THE PROPER STANDARD OF FAULT FOR IMPOSING PERSONAL LIABILITY ON CORPORATE DIRECTORS FOR FALSE OR MISLEADING STATEMENTS IN PROXY SOLICITATIONS UNDER SECTION 14(a) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SEC RULE 14a-9

I. INTRODUCTION TO CAUSES OF ACTION AGAINST DIRECTORS UNDER SECTION 14(a) AND RULE 14a-9

Section 14(a) of the Securities Exchange Act of 1934[1] provides for regulation by the Securities and Exchange Commission (SEC) of the solicitation of proxies to be voted at shareholder meetings. The section makes it unlawful for any person to solicit or allow the use of his name to solicit a proxy or consent with regard to any registered security in violation of SEC rules and regulations. As part of the implementation of this section, the SEC adopted rule 14a-9,[2] which forbids proxy solicitations which contain false or misleading statements of material facts, or which omit material facts necessary to prevent statements made from being false or misleading. According to one team of commentators, "The federal legislation and the Commission rules were enacted to place certain security holders in the position they would occupy if they could attend shareholder meetings and ask intelligent questions to which they would receive true and complete answers."[3]

Section 14 contains only a blanket prohibition of certain conduct and does not provide for civil or criminal liability for violation of that prohibi-

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[1] 15 U.S.C. § 78n(a) (1970) provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title [Securities Exchange Act of 1934, § 12].

[2] 17 C.F.R. § 240.14a-9 (1973), entitled "False or misleading statements," provides in pertinent part:

> (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

The forerunner of Rule 14a-9 was Rule 14a-5, which was promulgated in 1938 under Reg. X 14. The former rule was substantially the same as the present one, with the exception of the present language requiring the correction of prior statements which was added in 1940, and a note added to the body of the rule in 1956, which lists examples of misleading facts.

[3] Sowards and Mofsky, *Federal Proxy Regulations: Recent Extension of Controls*, 41 ST. JOHN'S L. REV. 165, 165-66 (1966).

tion. However, since *J. I. Case Co. v. Borak*,[4] a private right of action, both direct and derivative, has been implied in § 14(a) for violation of its provisions and of the rules and regulations implementing the section. The *Borak* Court said, "Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements."[5] In most of the reported proxy cases prior to *Borak* only equitable relief was sought, and the relief given was usually addressed to recirculating the proxy materials or undoing the vote of the shareholders.[6] But the Supreme Court made it clear in *Borak* that not only prospective relief, but also all necessary remedial relief, including damages, could be awarded by federal courts in § 14(a) actions.

There is no requirement under the Securities Exchange Act of 1934 that the directors of a corporation sign proxy material, approve it, or even see it, except in the case of a contested election to the board of directors.[7] There are, however, several ways, other than by signing proxy statements, in which directors can be exposed to liability for misstatements or omissions in proxy materials. A director might, for instance, prepare proxy materials or supervise their preparation, participate in solicitation of proxies by the board of directors, or allow his name to be used in the solicitation of proxies. Furthermore, if, as part of the management's solicitation, the board of directors makes recommendations to the shareholders on questions to be considered at the shareholder meeting, individual directors can be found to be directly soliciting proxies for management unless they disassociate themselves from the board's recommendations.[8] Many directors are also corporate officers, and, as part of management, they may be direct

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4 377 U.S. 426 (1964).

5 *Id.* at 432.

6 *See, e.g.*, Gaudiosi v. Franklin, 166 F. Supp. 353 (E.D. Pa. 1958), *aff'd and appeal dismissed in part*, 269 F.2d 873 (3d Cir. 1959), *cert. denied*, 361 U.S. 902 (1959); Butler Aviation Int'l, Inc. v. Comprehensive Designers, Inc., 307 F. Supp. 910 (S.D.N.Y. 1969), *aff'd*, 425 F.2d 842 (2d Cir. 1970); Dillon v. Berg, 326 F. Supp. 1214 (D. Del. 1971), *aff'd*, 453 F.2d 876 (3d Cir. 1971); Union Pacific R.R. v. Chicago & North Western Ry., 226 F. Supp. 400 (N.D. Ill. 1964).

7 Rule 14a-11, 17 C.F.R. § 240.14a-11 (1973).

8 In Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 858 (D. Del. 1972), Chief Judge Wright held that an outside director who had not disassociated himself from the reccommendations of the board of directors contained in the proxy materials, was a participant in the solicitation of proxies. According to Judge Wright:

> The S.EC. regulations afford a dissenting director an opportunity to disassociate himself from the Board of Directors' recommendations, C.F.R. § 240.14a-101(3)(a)(1); however, such disavowel [sic] must be made in the form of written notice to the Board. Id. [The director] gave no such written notice, and, in fact, not only supported the Board's recommendations, but also approved a draft form of the proxy materials. The failure to effect such notice and to apprise the shareholders of any objections he had to the proxy materials cast [the director] in the role of a person soliciting proxies on behalf of management.

participants in management's solicitation of proxies. Finally, under state law, the board of directors may comprise the management of the corporation, and thus a solicitation of proxies by management would necessarily involve the directors as participants unless the directors individually disassociate themselves from the solicitation.[9] In general then, a routine performance of his duties can subject a director to liability for participation in a proxy solicitation in which inadequate disclosure was made.

Although rule 14a-9 is often referred to as an anti-fraud rule, recovery for violation of the rule can be had without proof of all the elements of common law fraud or deceit.[10] Specifically, there need be no reliance by the individual plaintiff on the misrepresentation,[11] nor intent on the part of the defendant to induce the plaintiff to act or fail to act in reliance on the misrepresentation. Nor need there even be any actual misrepresentation of fact, since an omission of a material fact suffices to establish liability if other statements are thereby made misleading or false. Section 14(a) and rule 14a-9 do not specify any requirement of scienter either, while in common law deceit actions there is a requirement that the plaintiff

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[9] Under Delaware law, the board of directors comprises the management of the corporation and is the sole body empowered to make proxy solicitations on behalf of management. DEL. CODE ANN. tit. 8, § 141(a), Campbell v. Loew's, Inc., 36 Del. Ch. 563, 134 A.2d 852 (Del. Ch. 1957). Thus, in the Gould case, *supra* note 8, the court would not accept the director's contention that he was not a part of management and thus not a participant in the management's solicitation of proxies. 351 F. Supp. at 858.

[10] The elements of a common law cause of action for deceit are 1) a false representation, ordinarily one of fact, made by the defendant, 2) knowledge or belief on the part of the defendant that the representation is false or lack on the part of the defendant of a sufficient basis of information to make the representation (this element is called "scienter"), 3) an intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation, 4) justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it, and 5) damage to the plaintiff, resulting from such reliance. W. PROSSER, TORTS § 105 (4th ed. 1971).

In general, the elements of a cause of action based on a violation of section 14(a) and rule 14a-9 are 1) a security registered under section 12 of the 1934 Act, 2) a solicitation of proxies by the defendant or with the authorized use of his name, 3) use of false or misleading statement(s) or omission(s) of facts resulting in statements being misleading or false, 4) materiality of the facts misstated or omitted, 5) damage to plaintiff's interests, 6) causal connection between the misstatement(s) or omission(s) and the injury to plaintiff's interests, and 7) culpability or fault on the part of the defendant under the appropriate standard of fault.

[11] "It is unnecessary for a plaintiff to establish his particular reliance if it can be demonstrated that the misrepresentation had a causative effect upon the vote of the stockholders as a group. Reliance may be inferred from the effect unless the defendant proves otherwise." Gerstle v. Gamble-Skogmo, 298 F. Supp. 66, 103 (E.D.N.Y. 1969). The need to show reliance in 14a-9 actions appears to have been eliminated by the requirements that the misstatements or omissions be of material facts (*i.e.*, "that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote," Mills v. Electric Auto-Lite, 396 U.S. 375, 384) and that the proxy solicitation itself be an essential link in the accomplishment of the transaction for which proxies were solicited. Reliance thus seems to be presumed once materiality and causation are shown. At any rate, the Supreme Court in *Mills* declined to adopt any requirement that the misstatement or omission be shown to have had a decisive effect on the shareholders' approval of the transaction, which requirement, the Court noted, would correspond to the requirement of reliance in common law fraud actions.

establish that the defendant knew or believed that the representation was in fact false, or that he at least had no grounds for making the representation.[12] Because the two provisions are silent with respect to the requirement of scienter, the question of the proper standard of culpability often arises, with plaintiffs contending that scienter is unnecessary and negligence is sufficient,[13] and defendants arguing (so far unsuccessfully) that a showing of scienter is essential to a 14a-9 cause of action.[14] Some plaintiffs have even contended that those soliciting proxies should be held strictly liable for damages resulting from misstatements or omissions of material facts,[15] but thus far no court has held defendants to such a standard.

The primary controversy, the one with which this note is concerned, has thus become whether negligence or scienter is the proper standard for liability in actions against directors. However, since there may be considerations present in the case of those corporate officials, including directors, who actually prepare the proxy materials, which might justify the imposition of a higher standard of care on such officials, this note confines itself to a consideration of only that standard appropriate for directors not so involved.

II. NEGLIGENCE AND SCIENTER STANDARDS IN RULE 14a-9 ACTIONS

By prohibiting misstatements and omissions of material facts in proxy materials, rule 14a-9 imposes upon those soliciting proxies the duty to disclose all facts which would normally tend to influence a reasonable stockholder in voting on the proposal for which his proxy is sought.[16] The question of the proper standard for imposing liability on directors under rule 14a-9 thus becomes a matter of determining at what point directors have so far satisfied their duty to the shareholders that they cannot fairly be held responsible for misstatements and omissions yet remaining in solicitation materials.

Under a negligence standard, a defendant would be deemed not to have satisfied his duty of disclosure if the proxy solicitation materials contain statements which the defendant "knew or should have known were false or misleading.[17] Such a standard would require directors to scrutinize proxy materials to ascertain the truth of the statements contained therein.[18] However, it is not clear to what lengths a director would have to go under

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12 See list of elements, *supra* note 10.

13 *E.g.*, Gould v. American-Hawaiian S.S. Co., 331 F. Supp. 981, 998 (D. Del 1971).

14 *E.g.*, Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 856-57 (D. Del. 1972).

15 *See id.* at 857.

16 Richland v. Crandall, 262 F. Supp. 538, 553 (S.D.N.Y. 1967).

17 *Id.* at 553 n.12 and Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 865 (D. Del. 1972).

18 Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 865 (D. Del. 1972).

this standard to assure himself of the truth of the statements, since the phrase "should have known" does not define the duty to know but just assumes it.

Most courts choosing a negligence standard in rule 14a-9 actions have not found it necessary to determine the minimal level of misconduct for which a defendant director could be held liable because they have found that the defendants in the cases before them actually knew of the misstatements or omissions.[19] It is possible, however, that courts defining the negligence standard in the future may read into § 14(a) the same high standard of care (due diligence) imposed by § 11 of the Securities Act of 1933[20] upon those responsible for registration statements. The court in *Escott v. BarChris Construction Corp.*[21] interpreted this § 11 "due diligence" standard to require that directors have reasonable grounds to believe in the accuracy and adequacy of the statements in the materials, and that the statements be independently verified by the directors.[22] This would be a difficult standard for directors to meet in rule 14a-9 situations. However, one court has suggested that to avoid liability under the negligence standard directors need only read proxy materials and correct statements which they know or should know are erroneous or misleading, and they need not actually "recalculate or reassemble financial or other reports absent some evident misstatement or irregularity which should be within the director's knowledge and [which] the exercise of reasonable care would necessitate either correcting or directing to the expert's attention."[23] Thus, the burden placed on a director by the negligence standard would vary depending on whether or not the duty of independent verification is imposed on directors.

As an alternative to the negligence standard in 14a-9 actions, courts could adopt a "modified scienter standard" which would not require actual knowledge of the omissions or misstatements in all circumstances. A violation of the duty of disclosure under such a standard would be established by a showing of knowledge of, or gross negligence or recklessness with respect to the false or misleading character of the misstatements or omissions in the proxy materials.[24] One court has already hinted, in rejecting

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19 *E.g.*, Norte & Co. v. Huffines, 304 F. Supp. 1096 (S.D.N.Y. 1968), *aff'd*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), Gould v. American-Hawaiian S.S. Co., 331 F. Supp. 981 (D. Del. 1971). In Gerstle v. Gamble-Skogmo, 298 F. Supp. 66 (E.D.N.Y. 1969), *aff'd*, CCH FED. SEC. L. REP. ¶ 93,983 (2d Cir. 1973), another case in which the court decided that the negligence standard was the proper one, the court also found that the defendants had actual knowledge of the material omissions; however, this case did not involve the personal liability of directors.

20 15 U.S.C. § 77k (1970).

21 283 F. Supp. 643 (S.D.N.Y. 1968).

22 *See* Note, *False and Misleading Proxy Statements*, 3 GA. L. Rev. 162, 193 (1968) suggesting a due diligence defense of this type for actions under rule 14a-9.

23 Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 865 (D. Del. 1972).

24 Advocacy of such a modified scienter standard by the defendants was noted by the

such a standard that it feared the standard might excuse directors from reading proxy statements.[25] However, such a fear would seem to be unfounded. The failure of a director to read proxy materials would logically make the director guilty of recklessness with respect to the truth of the matters in the materials, because he would have failed to assure himself, before the materials were sent to shareholders, that the statements in the materials were not untrue in the light of facts within his personal knowledge. Another method of achieving the same result would be to impute to individual directors as participants in the solicitation of proxies, knowledge of any misstatements or omissions of which they would have had knowledge had they read the proxy materials. Certainly their duty of care under the proxy rules should require as a minimum that they read the proxy materials.

The modified scienter standard outlined above would produce results divergent from those under a negligence standard which does *not* require independent verification in only one situation: that in which the defendant neither knew of nor acted recklessly with respect to the false or misleading character of misstatements or omissions, but in which he should have known of their false or misleading character. On the other hand, a negligence standard requiring independent verification of statements in proxy materials would often produce results startingly different from those under either a requirement of intent to defraud or deceive or a modified scienter requirement.

While under the negligence standard the burden is on the plaintiff to prove the defendant's knowledge or lack of reasonable care or due diligence,[26] under the modified scienter standard the burden might be put either on the plaintiff to show the appropriate scienter or on the defendant to show a lack of scienter.[27] Where the burden is on the defendant, his defense has been called a "good faith defense."[28]

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court in Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 857 (D. Del. 1972). A similar standard has been developed and employed innumerous cases dealing with § 10(b) and rule 10b-5 violations. *See e.g.*, Shemtob v. Shearson, Hamill & Co., 448 F.2d 442 (2d Cir. 1971); Globus v. Law Research Service, Inc., 418 F.2d 1276, (2d Cir. 1969) *cert. denied*, 397 U.S. 913 (1970); and Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964).

[25] In Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 867 (D. Del. 1972), the court said that an examination of the defendants' argument that they should not be held liable under a scienter standard since they might have relied on others to correct a statement that they knew was false and they might not have read the final versions of the proxy statement "demonstrates certain of the most obvious infirmities of the scienter standard."

[26] Richland v. Crandall, 262 F. Supp. 538, 553 n.12 (S.D.N.Y. 1967): "Accordingly the Court is of the view, and so charged the jury . . . that plaintiffs were required only to prove that the defendants knew or should have known of the statements and material facts, . . ."

[27] Section 9(e) of the 1934 Act, 15 U.S.C. § 78i (1970) allows suits by purchasers of securities for "wilful" violations of the section, thus requiring plaintiffs to prove scienter; and section 18 of the same Act, 15 U.S.C. § 78r (1970), makes good faith a complete defense, thus putting the burden on defendants to prove their good faith. The defendants in Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 856-58 (D. Del. 1972), contended

The negligence standard does more than the scienter standard to ensure that security holders will be furnished with all facts necessary to enable them to exercise their right of corporate suffrage fairly and intelligently. If only because it is stricter, the negligence standard puts the interest of directors in avoiding liability more firmly in line with the interest of shareholders in receiving complete information than does the more lenient scienter standard. But, as will be seen later, it is questionable whether Congress intended § 14(a) to provide shareholders with protection against unintentional but negligent nondisclosure, and this doubt also brings into question the propriety of the negligence standard.

III. SEARCHING FOR A STANDARD OF LIABILITY THROUGH STATUTORY CONSTRUCTION

Section 14(a) contains no express provision for liability for violations of rules and regulations implementing it. Thus Congress in drafting § 14(a), and the SEC in drafting Rule 14a-9, had no occasion expressly to prescribe any standards of liability. The language of § 14(a) and rule 14a-9 contains no reference to either scienter or negligence, but merely prohibits any person from violating SEC rules by including false or misleading statements in proxy materials or omitting material facts from them. The prohibition relates to the quality of the statements made and to the sufficiency of the disclosure, and none of the words used in either § 14(a) or rule 14a-9 contain any implications about culpability or lack of care on the part of those soliciting proxies. The words "false" and "misleading" are neutral with respect to culpability and care. Thus, the language provides support neither for claims that negligence is the proper standard nor for claims that scienter is the proper one.

Although the Supreme Court has defined certain of the elements of a cause of action under rule 14a-9,[29] it has not addressed itself to the question of the proper standard of fault. Thus, the lower federal courts have been left to decide the appropriate standard. All of the courts that have considered the question so far have concluded that scienter is not required.[30] However, these cases do not provide strong support for rejecting a scienter requirement since (1) only one of the courts considered

that by analogy the court should adopt a scienter standard with the burden of proof on defendants if the court was not willing to make proof of scienter an affirmative part of the plaintiffs' case.

[28] Berman v. Thomson, 312 F. Supp. 1031, 1035 (N.D. Ill. 1970); Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 863 (D. Del. 1972).

[29] In Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970), the Supreme Court gave a general explanation of the meaning of "materiality" and "causation" in 14a-9 actions.

[30] Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853 (D. Del. 1972); Berman v. Thomson, 312 F. Supp. 1031 (N.D Ill. 1970); Gerstle v. Gamble-Skogmo, 298 F. Supp. 66 (E.D.N.Y. 1969), *aff'd*, CCH FED. SEC L. REP. ¶ 93,983 (2d Cir. 1973); Norte & Co. v. Huffines, 304 F. Supp. 1096 (S.D.N.Y. 1968), *aff'd*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); Richland v. Crandall, 262 F. Supp. 538 (S.D.N.Y. 1967).

the question in depth[31], (2) not all of the cases concerned the personal liability of directors or officers,[32] and (3) almost all such conclusions were dicta.[33] These considerations suggest that the question of the proper standard is not settled and that more attention should be devoted to it.

Since the Supreme Court has found that § 14(a) implies a private cause of action for violations of its implementing rules,[34] it follows that a cause of action under rule 14a-9 is statutorily created. Therefore traditional methods of statutory construction should be appropriate in the search for the proper standard of fault. Since the language of the section is not amenable to a "plain meaning" approach, other methods of statutory construction must be applied, such as an examination of the legislative history of § 14(a) and a comparison of § 14(a) and rule 14a-9 with other sections of the 1934 Act and rules implementing the Act.

The language of § 14(a) indicates that the section was enacted primarily "for the protection of investors."[35] And the question of the proper standard of fault is directly related to the question of *how much* protection Congress intended to afford shareholders in the exercise of their right of corporate suffrage. The scope of this protection is best phrased in terms of the evils against which Congress sought to protect shareholders, i.e., whether Congress intended to protect them against unintentional but negligent non-disclosure of material facts or only against knowing or reckless nondisclosure. Consequently, in examining the legislative history of § 14(a), it is important to determine the evils against which the section was directed, since these should provide the keys to selection of the appropriate standard.

Three Congressional committee reports discuss the background and purpose of § 14(a). The first, a House committee report, states the following about regulation of proxy solicitation:

> Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of their interest and without an adequate explanation of the management policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purpose for which the proxies are to be used and have used

31 Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853 (D. Del. 1972).

32 Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969), *aff'd*, CCH FED. SEC. L. REP. ¶ 93,983 (2d Cir. 1973), concerned the liability of the surviving corporation in a merger.

33 See text to notes 48 through 65 *infra*. The conclusion in Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853 (D. Del. 1972), may not be dictum—see text following note 59 *infra*.

34 J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

35 See text of section 14(a) at note 1 *supra*.

> such proxies to take from the stockholders for their own selfish advantage valuable property rights. Inasmuch as only the exchanges make it possible for securities to be widely distributed among the investing public, it follows as a corollary that the use of the exchanges should involve a corresponding duty of according to shareholders fair suffrage. For this reason the proposed bill gives the Federal Trade Commission power to control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders.[36]

The language of the report indicates that Congress was concerned with the deliberate misuse of proxies to achieve ends which benefitted those in control of management. The references to the purposes for which insiders had misused proxies leaves no doubt that the abuses with which Congress was concerned occurred in situations where the insiders had actual knowledge of misstatements or of omissions of material facts.

The conclusion that Congress was concerned with situations in which those soliciting proxies acted with scienter is supported by the two other Congressional reports. The full text of the discussion of the proxy provisions in one Senate report is as follows:

> In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings. Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought. For example, in one case brought to the committee's attention, proxies were solicited by the president of a corporation by means of a letter which purported to describe certain transactions concerning which ratification by the stockholders was sought. The letter omitted all mention of other important details such as the previously granted secret options in the corporation's stock, and the president's individual interest in an underwriting agreement made by the corporation, which furnished the real motive behind the request for ratification. The solicitation in that case so far succeeded that not a single stockholder appeared at the meeting in person, and an employee of the company voted all proxies in favor of ratifying all acts and proceedings taken by the directors and officers of the corporation. The committee recommends that the solicitation and issuance of proxies be left to regulation by the Commission.[37]

This quotation also demonstrates Congress' concern with insiders deliberately concealing from shareholders the purposes for which their proxies are being sought, or at least making no attempt to inform stockholders of those purposes. Again, the evil sought to be eliminated is intentional abuse of the proxy system by self-dealing directors.

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[36] H.R. Rep. No. 1383, 73d Cong. 2d Sess. 13-14 (1934). Insiders are corporate officers and directors who are also officers.

[37] S. Rep. No. 792, 73d Cong. 2d Sess., 12 (1934).

This same example of insider self-dealing was cited again and at more length in a second Senate report on stock exchange practices. The section of the report concerning proxies opens with the first two sentences of the Senate report quoted above and then gives the details of that proxy solicitation by the American Commercial Alcohol Corporation, after which the report asserts, "The letter to the stockholders and the proxy requested the stockholders to ratify the acts of the very officers and directors who were betraying them by participating secretly in the underwriting agreement and pool operation, from which they obtained substantial profits."[38] Finally, after excerpts from the testimony of a director involved in the fraud and a discussion of the practice of carrying stock in brokers' names, the report summarizes § 14 and concludes:

> It is contemplated that the rules and regulations promulgated by the Commission will protect investors from promiscuous solicitation of their proxies, on the one hand, by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials; and, on the other hand, by unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts.[39]

The language used in the report would seem to indicate that Congress' primary concern was with those corporate officials who engage in the solicitation of proxies with an actual intent to deceive. Thus, all three Congressional reports demonstrate concern about intentional or reckless acts by corporate officials which deceive shareholders, rather than about good faith attempts at disclosure in which some facts were unintentionally and unknowingly misstated or omitted. The modified scienter standard which imposes liability for knowing, reckless, or grossly negligent misstatements or omission of material facts would satisfy the concern expressed in these reports with respect to both "unscrupulous corporate officials" and "irresponsible outsiders."

The legislative history of § 14(a) provides considerable support for proponents of the modified scienter standard.[40] However, federal courts have thus far been reluctant to regard the legislative history as decisive in determining the proper standard of fault.[41] On the one hand, the committee reports fail to show that Congress was not concerned with negligent misrepresentation when adopting § 14 or that Congress did not contem-

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[38] S. Rep. No. 1455, 73d Cong. 2d Sess., 75 (1934).

[39] *Id.* at 77.

[40] There is certainly no basis in the legislative history of § 14(a) for the unsupported assertion of one court that "[i]t is apparent from the Congressional purpose in acting Section 14(a) and from the adoption of Rule 14a-9 by the Commission, that scienter is not required in such an action." Gerstle v. Gamble-Skogmo, 298 F. Supp. 66, 101 (E.D.N.Y. 1969).

[41] The court in Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853, 860 (D. Del. 1972), in response to the arguments of the defendants that the legislative history supported a scienter requirement for actions under § 14(a), asserted that "[t]he legislative history as cited by the three defendants provides no significant assistance."

plate that the SEC would proscribe negligent misrepresentations in order better to guard against director's recklessness in regard to the accuracy and adequacy of disclosure. Only the *complete* scope of the protection intended by Congress is decisive on the question of the proper standard, and, therefore, if the reports demonstrate only part of Congress' concern, the legislative history cannot be the sole basis for choosing a standard. On the other hand, the reports do indicate that Congress was confronted with flagarant abuses of the proxy solicitation process and clearly set out to remedy them, that the question of good faith attempts which did not fully succeed because of unintentional but negligent misstatements or omissions was not before Congress, and that Congress was apparently not expressly concerned with instances of negligent nondisclosure. This note will therefore pursue a second method of statutory interpretation: a comparison of § 14(a) and rule 14a-9 with other sections of the securities laws and with other rules.

Comparing § 14(a) and rule 14a-9 with other anti-fraud sections of the 1934 Act does not determine the question of the proper legal standard. It is true that the 1934 Act expressly grants a money recovery only in instances where scienter is shown.[42] But from this fact it can be argued with equal logic that all sections of the 1934 Act should be interpreted to require scienter, or that no other sections require scienter because Congress could have specifically so provided if such had been its intention. It might also be pointed out that there are significant similarities in language in rule 14a-9, rule 10b-5,[43] and § 17(a)(2) of the Securities Act of 1933,[44] and that a scienter requirement *has* been found under both

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[42] *See* § 9 and § 18 of the Act, 15 U.S.C. §§ 78i, 78r (1970).

[43] 15 U.S.C. § 78j(b) (1970) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1973), provides:

> It shall be unlawful for any person . . .
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
> in connection with the purchase or sale of any security.

[44] 15 U.S.C § 77q(a) (1970) provides:

> (a) It shall be unlawful for any person in the offer or sale of any securities . . .
> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

§ 17[45] and rule 10b-5.[46] All three provisions prohibit untrue statements of material facts and omissions of material facts which render misleading the statements made. The similarity of the prohibitions and the imposition of a scienter standard by courts in actions under rule 10b-5 and § 17 support a similar requirement for rule 14a-9 actions.

However, there are also significant differences in the language of the three provisions which argue against making the standards the same in all three cases. The titles of § 10(b) and rule 10b-5 contain the phrase "Manipulative and Deceptive Devices," and rule 10b-5 prohibits the use of "any device, scheme, or artifice to defraud" as well as misstatements and omissions of material facts. Section 14(a) and rule 14a-9 contain only a plain prohibition against misstatements and no language relating to intentional fraud. Sections 14, 10, and 17 also cover substantially different areas of securities regulation, so that the standards need not be the same under all sections. Section 10 covers the purchase and sale of securities, § 14 covers the solicitation of proxies, and § 17 covers offers or sales of securities in which the person making the untrue statements obtains property or money by means of the untrue statements. It is ironic that the imposition of a negligence standard under § 14 would result in a higher standard of care being imposed on those who solicit proxies than on those who directly benefit from persons who invest in reliance on misrepresentations. Thus, those who are enriched by unintentional misrepresentations would not be held accountable, while proxy solicitors who have not necessarily gained personally would be held to account for shareholder losses. That this result was intended by Congress is doubtful.

The above comparisons provide no clear answer to the question whether scienter is necessary in 14a-9 actions, since equally logical arguments resulting from the comparisons can be made for both positions. Consequently, it will be necessary to turn to other means of determining the appropriate standard of fault.

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(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[45] Larson v. Tony's Investments, Inc., 46 F.R.D. 612 (M.D. Ala. 1969) and Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964).

[46] Many cases have construed rule 10b-5 to require a showing of scienter in suits for damages, although the circuits are split on the issue. Cases requiring scienter are: Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333 (S.D.N.Y. 1969); Globus v. Law Research, 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970); Shemtob v. Shearson, Hamill & Co., 448 F.2d 442 (2d Cir. 1971); Matheson v. White Weld, 53 F.R.D. 450 (S.D.N.Y. 1971); Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir. 1972) (Adams, J., concurring and dissenting); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970).

Cases holding that proof of scienter is not necessary are: Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1962).

IV. Setting the Proper Standard on Policy Grounds

A. *Methods of Decision Open to Courts*

Courts faced with the question of the proper standard of fault for imposing liability on directors in 14a-9 actions have open to them several methods of reaching a decision. They may avoid a thorough consideration of the problem altogether by holding that absent a showing that scienter should be required there is no reason to impose such a standard, and that negligence is sufficient to warrant recovery. Or, alternatively, the courts may point to the "remedial purposes" of § 14(a), emphasized in *Borak*,[47] and to the language of § 14(a) empowering the Commissioner to adopt regulations "for the protection of investors," and conclude that a negligence standard would produce greater protection than a scienter standard. This second method merely begs the question, since it is based on the implicit assumption that Congress intended to provide protection against more than intentional or reckless failure to make full disclosure in proxy solicitation.

Preferably, however, courts will recognize that their decision is one as to which the intent of Congress is not clear, and that the decision must be made on policy grounds. The policy of § 14(a) puts more weight on the side of shareholder interests than there was before the adoption of the 1934 Act, but the courts still must consider the relative weight of all the factors involved in determining how far to the shareholder's side the balance has now shifted.

B. *Methods of Decision Employed by Courts to Date*

Those courts which have set a standard of fault in damage actions under rule 14a-9 have either rejected a scienter standard or specifically adopted a negligence standard. But in almost every case in which such a decision was made, it was unnecessary to the disposition of the case. Not all of the cases involved the personal liability of directors, and few of the courts gave extensive consideration to the proper standard. Only one court made the decision on policy grounds, and, as will be seen below, that court failed to consider all relevant factors.

The first case to adopt negligence as the proper standard was *Richland v. Crandall*.[48] In a footnote to the opinion, the court remarked that § 14(a) and rule 14a-9 do not contain language associated with an intent to defraud as do § 10(b) and rule 10b-5, and concluded that plaintiffs are not required to show an intent to defraud, but need only show negli-

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[47] 377 U.S. 426 (1964).

[48] 262 F. Supp. 538 (S.D.N.Y. 1967).

gence.[49] The difference in language was thus the sole basis for the court's conclusion, and this seems to be a somewhat restrictive approach in view of the legislative history and the competing interests involved. However, the conclusion was pure obiter dictum, since the court found that the proxy statement did not in fact misstate or omit any material fact.

The same court decided *Norte & Co. v. Huffines*,[50] an action against corporate directors alleging, among other things, a violation of rule 14a-9. The court mentioned only in passing that rule 14a-9 actions do not require a showing of actual knowledge, but provided no discussion supporting that statement of law because the court found that the defendants had had actual knowledge of the misstatements and omissions.[51]

The court in *Gerstle v. Gamble-Skogmo, Inc.*,[52] also decided that negligence is sufficient to warrant recovery in 14a-9 actions. The court pointed out that it had adopted a scienter requirement in 10b-5 actions in order to avoid having different remedies for the same offense under § 10(b) of the 1934 Act and §§ 11 and 12(2) of the 1933 Act.[53] It implied that no similar problem existed with regard to rule 14a-9. Additionally, the court noted that a literal reading of § 14(a) and rule 14a-9 does not reveal any scienter requirement,[54] and asserted without elaboration, "It is apparent from the Congressional purpose in enacting Section 14(a) and from the adoption of Rule 14a-9 by the Commission, that scienter is not required in such an action."[55] But the court did not discuss the possibility that other relevant factors[56] might well outweigh these reasons thus requiring scienter as a more advisable standard than negligence. However, *Gerstle* did not involve the personal liability of directors, and the court's conclusion that negligence is a sufficient basis for liability is dictum here too, because the court found that Skogmo's nondisclosure of certain material facts was intentional.[57] Moreover, in affirming the lower court's decision the Second Circuit did not extend the application of negligence as the proper standard to cases beyond those in which the defendant participated in the preparation of the proxy statement and was the beneficiary of the proxy vote.[58]

In *Berman v. Thomson*,[59] the court, in effect, assumed the answer

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49 *Id.* at 553 n.12.

50 304 F. Supp. 1096 (S.D.N.Y. 1968), *aff'd*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

51 *Id.* at 1109-10.

52 298 F. Supp. 66 (E.D.N.Y. 1969), *aff'd*, CCH FED. SEC. L. REP. ¶ 93,983 (2d Cir. 1973).

53 15 U.S.C. §§ 77k, 77*l*(2) (1970).

54 298 F. Supp. at 97.

55 *Id.* at 101.

56 See text accompanying notes 66-90 *infra*.

57 298 F. Supp. at 101.

58 Gerstle v. Gamble-Skogmo, CCH FED. SEC. L. REP. ¶ 93,983 (2d Cir. 1973).

59 312 F. Supp. 1031 (N.D. Ill. 1970).

to the question of the proper standard by holding that recognition of a good faith defense would not further the statutory policy of full disclosure.[60] The court's reliance on the statutory policy of full disclosure involved an assumption that Congress intended to protect investors against non-reckless, unintentional nondisclosure, an assumption which does not find express support in the legislative history of § 14(a).

The one case which does attempt a consideration of policy grounds is *Gould v. American-Hawaiian Steamship Co.*[61] On a motion to vacate the partial summary judgment which had been granted on the issue of the liability of several directors, Judge Wright had plaintiffs and defendants submit memoranda on the issue of the proper standard of fault. In his opinion denying the motion, he considered the language of the statute, the legislative history of the section, the policies behind the 1934 Act, the importance of informed corporate suffrage, the position of directors in corporations, and the effect of the various standards in promoting full disclosure.

Judge Wright rejected a standard of absolute liability because he believed it would create serious practical problems for directors and would not fulfill other purposes of the securities acts. The court's main point was that strict liability would provide persons more incentive not to become directors than to accept positions as directors and the concomittant responsibility to scrutinize proxy materials especially when efforts at active and rigorous scrutiny would be of no significance in precluding liability for misstatements against which a director cannot reasonably guard.[62]

In choosing a negligence standard Judge Wright stressed the following factors: dicta in other decisions that scienter is not essential to a § 14(a) action, the importance of corporate suffrage, the importance of adequately informed stockholders, the limited scope of § 14(a), the position of fiduciary trust which directors occupy in relation to potential plaintiffs (shareholders), and the incentive which a standard of reasonable care gives to directors to scrutinize proxy materials and guard against liability.[63]

It is not clear whether the *Gould* court's choice of the negligence standard was dictum or not. The decision denied the motion to vacate but reliance on a modified scienter standard would not have required a different result because the court had previously determined that the defendants against whom summary judgment was granted had known of the misstatements and omissions.[64] But the negligence standard, once chosen,

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[60] *Id.* at 1035.

[61] 351 F. Supp. 853 (D. Del. 1972).

[62] *Id.* at 859.

[63] *Id.* at 864-65.

[64] 331 F. Supp. at 998.

would necessarily be applied to the other defendants against whom summary judgment had not been granted.[65]

Because of its consideration of factors that other courts have passed over, the *Gould* decision is the most significant of all opinions on the proper standard of fault. However, the decision may be criticized because it did not consider, or at least did not discuss, other equally important factors which might have changed the result.

C. *Factors Which Courts Have Failed to Consider*

The fact that damages in rule 14a-9 suits may be enormous, wholly dependent on market movements and unrelated to any possible unjust enrichment of directors[66] should cause courts to pause before they subject directors to liability under a strict negligence standard. In *Gould* the defendant directors were faced with the possibility of being held liable for damages in the astronomical sum of $24 million.[67] The expanding litigation under the securities laws in recent years has already created an atmosphere of uneasiness and uncertainty among corporate officials, and the adoption of a negligence standard for imposing liability on directors for such large amounts in 14a-9 actions can only increase that uneasiness. One commentator has written that the atmosphere of uncertainty created by the highly publicized federal securities law decisions of the 1960's even caused some persons to resign their outside directorships.[68] Furthermore,

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[65] 351 F. Supp. at 857 n.3.

[66] In Gerstle v. Gamble-Skogmo, 298 F. Supp. 66, 104 (E.D.N.Y. 1969), the district court held that accounting and restitution were the proper remedies for the plaintiffs and decreed:

> After proper deduction for Skogmo's proportionate interest in General's assets as of the date of the merger, plaintiffs are entitled to the highest value since the date of the merger of all the assets transferred to Skogmo by General including post-merger appreciation of said assets less (i) Skogmo's proportionate share thereof, and (ii) the value of Skogmo stock as of the date of the merger received by those shareholders who have exchanged their shares or to be received by those who have not yet exchanged their shares.

Although defendant Skogmo Corp. was actually enriched by the merger and thus was only forced to return what it had gotten by illicit means, when directors are defendants in 14a-9 suits and the challenged transaction is a merger, the surviving corporation rather than the directors of the disappearing corporation, would have received any benefit from the violations of rule 14a-9. In such a situation, the measure of damages which the defendant directors would be liable to pay to plaintiffs would still be measured either as in *Gerstle* or computed according to what the correct stock exchange ratio of surviving corporation stock for disappearing corporation stock should have been because the loss to the plaintiffs in the transaction would be the same no matter who the defendant is and no matter who benefitted from the transaction. Thus what the directors would have to pay, if damages are computed as in *Gerstle*, would be dependent on changes in the market value of the assets of the non-surviving corporation from the date of the merger to the date of the judgment. These changes could be substantial considering the potentially long span of time between the challenged transaction and the final judgment.

[67] Memorandum of Defendants Ludwig and Kroeger at 22, Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853 (D. Del. 1972).

[68] Johnston, *Developing a Protection Program for Corporate Directors and Officers*, 26

the spectre of enormous damage judgments can hamper effective decision-making by corporate officers and directors. This possibility was recognized by the Internal Revenue Service when it issued a revenue ruling allowing premiums paid by corporations for director and officer liability insurance to be deducted as a business expense on the theory that the corporation receives the primary benefit from such insurance, because insurance allows officers and directors to make necessary corporate decisions without fear of legal entanglement.[69]

Since some men who were already directors have been so alarmed by the possibility of enormous judgments that they have resigned directorships, courts should be aware that a negligence standard would tend to scare off other capable men from accepting directorships. In 1969 the Wall Street Journal reported that: "[S]cores of men are politely declining offers they once would have jumped at to serve on prestigious boards. . . . There now is a real shortage of competent men willing and able to serve as directors."[70] It is doubtful that the interests of investors would be served by a negligence standard that would scare off responsible, competent men from accepting the responsibility of managing the corporations in which shareholders' money is invested.

Courts should also be conscious that the extension of liability under a negligence standard is not necessary to cover morally blameworthy actions of directors. In situations where self-dealing or unjust enrichment is present, as in *Norte & Co. v. Huffines*,[71] a scienter standard would provide adequate relief to the injured parties. It can also be argued that, unlike intentional deception or recklessness, negligence does not involve sufficient moral blameworthiness to justify holding directors liable for the omission of material facts from proxy statements.

Courts should also consider the present relative inability of directors to spread the cost of judgments recovered against them for 14a-9 violations. If it were possible for directors to spread judgment costs through corporate indemnification and liability insurance, holding directors to a standard as strict as a negligence standard would be much more justifiable than at present. Nearly all states have statutes relating to the indemnification of corporate directors and officers, some requiring indemnification under certain circumstances,[72] some merely allowing indemnification,[73] and some requiring court approval.[74] However, most state laws do not permit

BUS. LAW. 445 (1970). Outside directors are those directors who are not also corporate officers. See text accompanying notes 82 and 83 *infra*.

69 Rev. Rul. 69-491, 1969-2 Cum Bull. 22.

70 Wall Street Journal, March 13, 1969, at 1, col. 6.

71 *See* notes 50-51 *supra*, and accompanying text.

72 *E.g.*, DEL. CODE ANN., tit. 8, § 145(c) (West Cum. Supp. 1968).

73 *E.g.*, DEL. CODE ANN., tit. 8, § 145(a) (West Cum. Supp. 1968); OHIO REV. CODE § 1701.13(E) (Page 1964); KY. REV. STAT. § 271A.025(1) (Baldwin 1969).

74 *E.g.*, CAL. CORP. CODE § 830 (West 1955).

corporations to indemnify a director in either a derivative or third party action in which the director is found liable for negligence or misconduct in the performance of his duties.[75] Thus, in most cases in which a director would be found liable under a negligence standard indemnification would not be available.[76] Moreover, many times when the directors are sued instead of the corporation, it is because the corporation is either no longer in existence or is insolvent, making it impossible for the directors to receive indemnification from the corporation. Therefore, unless directors have insurance covering such liability, they would have to bear the expense of damage judgments alone. If indemnification were more readily available, it would encourage men to accept the responsibility of directorships by bringing the risk of loss under the negligence standard into a better balance with the rewards of the post.[77]

Insurance covering the liability of corporations and corporate officers and directors is available, but it is very expensive and only a minority of all applicants receive coverage,[78] which means that an even smaller minority of all corporate directors are covered by such insurance. Such insurance policies do not ordinarily cover outright fraud or intentional wrongdoing or losses caused by the dishonesty of the insured.[79] These exclusions and the amounts deductible from coverage on each claim for each insured and for the corporation (generally $5,000 to $100,000 plus 5% of losses above this amount[80]) keep the insurance from being a complete insulation against liability and thus preserve the incentive for directors to avoid misstatements and omissions.

If indemnification and liability insurance were more readily available for coverage of 14a-9 judgments, they would permit a wider distribution of the losses under a negligence standard. The premiums for such insurance are deductible to the corporation as business expenses,[81] and the same principle should apply to amounts spent by corporations to indemnify directors for expenses and judgments in securities actions. Thus, the bur-

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[75] Note, *Indemnification of the Corporate Insider: Directors' and Officers' Liability Insurance*, 54 MINN. L. REV. 667, 674 (1970). *E.g.*, OHIO REV. CODE ANN. § 1701.13(E) (Page 1964).

[76] However, statutes such as DEL. CODE ANN. tit. 8, § 145(a) (West Cum. Supp. 1968) and KY. REV. STAT. § 271A.25(1) (Baldwin 1969), which follow Section 5 of the Model Business Corporation Act, promulgated by the American Bar Association and the American Law Institute in 1967, do allow a corporation to indemnify a director or officer against expenses (including attorney's fees), judgments, fines, and amounts paid in settlement reasonably incurred in the suit if the director acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation.

[77] KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS (1973 ed.), § 16.01, at 406.

[78] In 1969 it was estimated that only 25% of all applicants received coverage. *Id.* § 17.07, at 440-41.

[79] *Id.* § 17.01, at 430.

[80] *Id.* § 17.06, at 438, § 17.12, at 450.

[81] Rev. Rul. 69-491, 1969-2 Cum. Bull. 22.

den of director liability would be spread over all insured corporations and directors, over the United States Treasury (by means of the deduction for premiums as business expenses), over the individual directors who have to pay part of the premiums and part of the judgments, and ultimately over all shareholders of the corporations in the form of reduced dividends.

If a director could receive insurance coverage or be eligible for indemnification from his corporation, the prospect of his being held liable under a negligence standard would not appear so devastating to him. Yet it would still be a deterrent to negligent acts because of the deductible amounts not covered by the policy. Thus, competent men would not be as frightened by the negligence standard as they would be if they had to bear the judgment costs alone. However, the present relative unavailability of insurance and indemnification and the resulting inability of directors to spread the costs of judgments in 14a-9 actions make the exposure to liability under the negligence standard a heavy burden. A recognition of the hardship which the negligence standard places upon directors, and of the consequent detrimental effects to corporations and to investors' interests from the resulting shortage of competent directors, should indicate to courts the need to adopt a modified scienter requirement in rule 14a-9 actions.

D. *The Advisability of a Modified Scienter Standard for Outside, Non-involved Directors*

Not all directors are equally involved in corporate affairs. "Inside" directors, who are corporation executives as well as directors, manage the business of the corporation, while their "outside" counterparts who are not corporate officers, "spend most or all of their working time in another business, but lend their management skills and judgment to provide a fresh outlook on the business that might be somewhat more parochial if only full-time employees of the companies were on the board."[82] Outside directors often sit on boards because they represent public interest groups or large stockholders or because of the prestige they have achieved in other fields.[83]

The considerations set out in the preceding section argue with particular force for a modified scienter standard in the case of outside directors who were not involved in planning the transactions to which misstatements or omissions in the proxy materials relate. It would be especially unfair to hold such directors to a negligence standard of the "due diligence" type, which requires that a director have reasonable grounds to believe in the

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[82] Securities Regulation and Transfer Report, April 20, 1973, at 2.

[83] Address by SEC Chairman Cook, April 6, 1973, CCH FED. SEC. L. REP. ¶ 79,302 at p. 82,917.

accuracy and adequacy of the proxy material and independently verify the statements in the materials.[84]

An outside, non-involved director has less opportunity to gain information about the details of corporate activity in general and about specific transactions (such as mergers) treated in proxy statements than do inside and involved directors. Thus, an outside, non-involved director is not in a good position to know the truth and adequacy of statements in proxy materials. Then SEC Chairman G. Bradford Cook recently criticized some courts for not giving due consideration to "the fact that outside directors of companies often are effectively blocked by inside directors from getting vital information to make informed judgments on corporate affairs."[85] Mr. Cook said that outside directors can contribute to today's heightened sense of corporate social responsibility,[86] but that courts which have held outside directors to the same standards of diligence as the inside directors have placed an intolerable burden on them which will deter good men from serving as outside directors.[87] Considering the fact that outside directors usually come to the position with little technical expertise, he said, the automatic imposition of broad liability on all persons bearing the title of director is clearly not in the public interest.[88]

To be sure, it is not too much to require an outside director to read the proxy material and correct any misstatements or omissions of facts within his knowledge. But to require him to verify independently all statements made in such materials by testing them against facts which might not be known to him, would be, in the words of Judge Learned Hand, "practically to charge him with detailed supervision of the business, which, if consistently carried out, would have taken most of his time. If a director must go so far as that, there will be no directors."[89] Judge Hand's remarks were made in reference to a suit against an outside, non-involved director based on his company's use of a circular to sell stock in the company. The claim in the case, *Barnes v. Andrews*,[90] was based on New York corporation law, but Judge Hand's remarks are equally applicable to outside directors facing liability in rule 14a-9 actions.

To require outside, non-involved directors to verify independently the proxy statements prepared by highly qualified lawyers, brokers and accountants would be to require them either to become so totally involved in

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84 See text accompanying notes 20-22 *supra*.

85 Address by SEC Chairman Cook, April 6, 1973, CCH FED. SEC. L. REP. ¶ 79,302 at p. 82,919.

86 *Id.* at 82,917.

87 *Id.* at 82,916.

88 *Id.* at 82,917. Mr. Cook also said that the SEC plans to issue soon a position paper on the standards which directors must adhere to in order to discharge their obligations under the securities laws. However, Mr. Cook is no longer SEC Chairman.

89 Barnes v. Andrews, 298 F. 614, 620 (S.D.N.Y. 1924).

90 *Id.*

corporate affairs that they lose their status as outside directors or to become insurers of the accuracy and adequacy of proxy statements prepared by others. No outside director could afford to open himself to the risk created by the second choice. Thus, subjecting outside directors to a due diligence standard could effectively eliminate such directors from corporate boards, depriving the corporation and the corporate management of their detached and critical insight into the affairs of the corporation. To avoid such a loss to corporations and their shareholders, courts should at least adopt a modified scienter standard for outside, non-involved directors. Such a standard would protect investors by holding outside directors to a minimum duty of reading proxy materials and correcting inadequacies and inaccuracies within their knowledge but would not impose too great a burden on outside directors. Choosing this standard for outside directors would, of course, not preclude courts that were so inclined from imposing a higher standard on corporate officers and directors actually involved in the transactions to which the proxy materials relate, or on those officers and directors actually involved in the preparation of the proxy materials.

V. Conclusion

The policy of § 14(a) and rule 14a-9 is to ensure that security holders be furnished with the opportunity of intelligently and fairly exercising their right of corporate suffrage. But the language of the section and of the rule does not disclose the standard of fault required for imposition of liability. Although the legislative history of § 14(a) may not be determinative of the question, it does suggest that Congress enacted § 14(a) to guard against intentional or reckless misrepresentations or omissions of material facts. However, lower federal courts unwilling to rely on legislative history may prefer to handle the problem strictly in terms of policy considerations. Among the factors which should be weighed in reaching a decision are: the effect of the imposition of a negligence standard on the willingness of competent men to accept the responsibility of directorships, the enormity of possible damages in situations in which directors lack moral blameworthiness, and the present inability of directors to spread the cost of judgments by means of liability insurance and corporate indemnification. These factors make advisable a modified scienter standard for directors and militate strongly for such a standard in the case of outside, non-involved directors.

Stephen Robert Schmidt